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IN THE

Supreme Court of the United States

October Term, 1972

No. 71-1645

COY L. WEAVER AND HELEN F. WEAVER, Petitioners

v.

RICHARD M. HUTSON, II, TRUSTEE OF LANDMARK INNS OF DURHAM, INC., Respondent

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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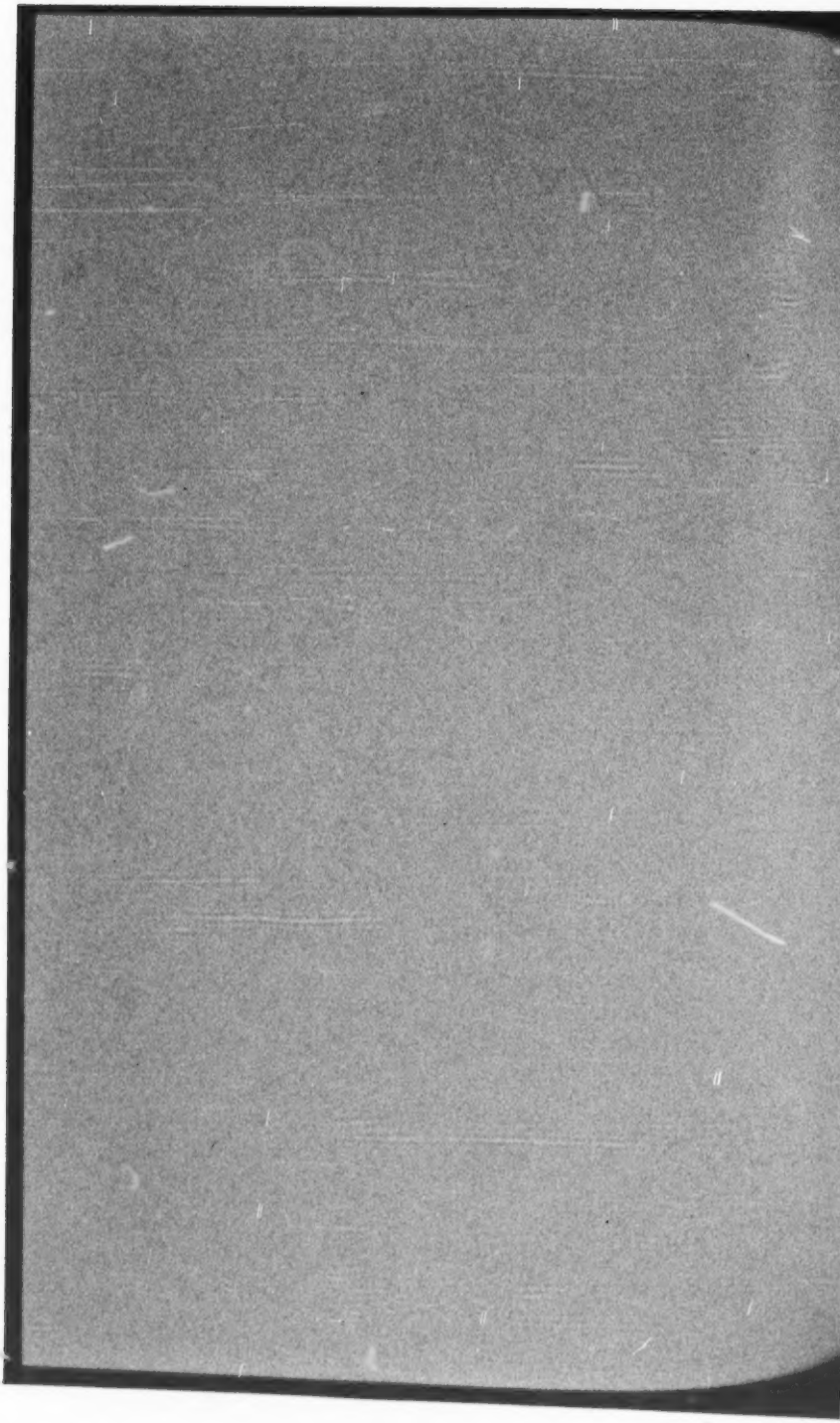

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Question Presented

Whether the United States District Court, in proceeding under Chapter X of the Bankruptcy Act, properly exercised its equitable discretion in declining to enforce a forfeiture provision in a lease when such forfeiture would abort any successful reorganization attempt in the proceeding and result in a $1,000,000.00 windfall to the Landlords at the expense of creditors and public stockholders of the Debtor corporation?

Statement of the Case

This is a petition by the Landlords (Petitioners) of Landmark Inns of Durham, Inc., a corporation proceeding under Chapter X of the Bankruptcy Act, from a decision of the United States Court of Appeals for the Fourth Circuit, dated February 28, 1972, and an order denying a rehearing dated March 31, 1972. (Pet.App. 30a)

During 1964 the Debtor's predecessor entered into a 52-year lease agreement with the Petitioners. The leased premises is adjacent to the Veterans Administration Hospital in Durham, North Carolina, and approximately one-half mile from Duke University Medical

Center. The lease was later assigned to the Debtor corporation which caused to be constructed on the premises a modern motor hotel facility at a cost of $1,502,645.12. The building itself is eight stories high and contains 145 rooms and is built of reinforced concrete, steel and glass. It contains, in addition to the guest rooms, complete restaurant facilities, cocktail lounge, beauty shop, offices and three elevators. (Pet. App. 5a)

To finance the construction and initial cost, the Debtor corporation sold its common stock to 84 stockholders for the sum of $325,489.00 and in addition sold convertible debentures to 77 persons in the amount of $254,750.00 and sold non-convertible debentures to 14 persons in the sum of $100,500.00. The stock and debentures were purchased by individuals, including the original promoters and many citizens of the City of Durham. In addition to the sale of stock and debentures, capital was raised by permanent financing through Penn Mutual Life Insurance Company in the amount of $730,000.00 and a second mortgage in the amount of $110,000.00 to Chase Manhattan Bank. (Pet. App. 4a, 7a)

Because of financial difficulties, major creditors of the Debtor corporation filed a petition under Chapter X of the Bankruptcy Act, 11 U.S.C. 501 et seq., which was subsequently approved on September 12, 1969, and a Trustee was appointed by the District Court. (Pet. App. 16a, 17a)

The Landlords then petitioned the District Court to declare the lease forfeited because of certain breaches, all of which have been abandoned, except the breach because of institution of bankruptcy proceedings. The Landlords contend that because of the institution of bankruptcy proceedings, the lease is forfeited under paragraph 12, which provides:

> "This lease shall be terminated by any act of the Tenant, the result of which would be to pass by operation of law, or otherwise, any interest of estate in the leased premises to any Trustee or Receiver in bankruptcy. . . ."

At the time of the hearing of this matter in the District Court, the land owned by the Landlords was appraised for $150,000.00 and the motor hotel, constructed by the Debtor, was appraised for $1,955,000.00. The property is subject to a mortgage financing having a present balance of approximately $625,000.00 In the event that the Landlords would prevail in their forfeiture petition, they would take over the Debtor's only asset subject solely to the mortgage financing. This would result in a windfall of over $1,300,000.00 to the detriment of the trade creditors, debentureholders and stockholders having claims amounting to $878,530.60, plus interest. (Pet. App. 18a, 19a)

The operation of the hotel, under jurisdiction by the Trustee, has been very successful. All secured creditors and operating expenses are current and the Debtor corporation continues to show a profit and is in a position to be reorganized as soon as a determination in this cause is made. (Pet. App. 20a)

The Landlords have received in rental payments since the inception of the lease $117,083.05. The Trustee has paid a net rental to the Landlords of $26,584.58 in 1969-70 fiscal year and over $31,000.00 for 1970-71. (Pet. App. 20a)

The Referee In Bankruptcy, United States District Court and the United States Court of Appeals for the Fourth Circuit have all recognized the inherent equitable powers of the Courts under the Bankruptcy Act and steadfastly denied the Landlords relief.

Argument

The Petitioners contend that the Court of Appeals for the Third Circuit and Fourth Circuit have decided a Federal question concerning the enforceability of Section 70(b) of the Bankruptcy Act in conflict with the decisions of the Supreme Court of the United States. When one reviews these decisions, it is obvious that there is no conflict, and that the question of applicability and enforceability have always been separate and distinct.

In the case of *Finn v. Meighan,* 325 U. S. 300 (1945) this Court established that an express covenant in a lease provided for forfeiture of the leasehold interest was applicable to a proceeding under Chapter X of the Bankruptcy Act. The debtor in the *Finn* case was a large restaurant chain and this Court permitted the forfeiture of the one unit in question. The debtor in *Finn* neither had a substantial investment in the premises nor was it responsible for construction of the leasehold improvements and in addition had other restaurant units. In contrast, the Debtor in the case at bar has a $1,500,000.00 investment in leasehold improvements, a long term lease and a forfeiture of this lease would frustrate the entire reorganization proceeding.

Less than one year following the *Finn* decision, this Court made it clear in *Smith v. Hoboken,* 328 U. S. 123 (1946), that the question of the *enforceability* of a forfeiture covenant is separate and distinct from the question of whether enforcement in a particular case would be consistent with other provisions of the Bankruptcy Act. In *Smith,* the Court ruled that because of the public interest represented and because forfeiture would preclude the formulation of any plan of reorganization, that the lease should not be forfeited.

In the instant case, if forfeiture of the lease is now declared, no plan of reorganization may be possible in that the motel-hotel erected on the leased premises is the only asset of the Debtor corporation.

The rationale of *Smith v. Hoboken, supra,* was held controlling in a Chapter X case that is definitely on "all-fours" with the instant case. *In Re Fleetwood Motel Corp.,* 3rd Cir., 335 F. 2d 857 (1964). In that case, the debtor, like the Debtor here, built a motel on land that it had leased from others. Like this Debtor-Lessee, that debtor-lessee financed construction by selling securities to the public. There, as here, the publicly held debtor encountered financial difficulties and petitioned for corporate reorganization. The landlord then filed a petition to reclaim the premises on the basis that a forfeiture of the lease had occurred. The Court in refusing to allow such a forfeiture stated:

> "We think that the rationale of *Smith,* (Supreme Court Decision) coupled with the inherent equity powers of a Court of Bankruptcy, * * * provide abundant support for the conclusion of the District Court in the case at bar. * * * and obviously no plan of reorganization could be formulated if forfeiture were permitted, for the property which the landlord would obtain by such action is the only property of the debtor. * * * Suffice it to say they (factual circumstances) amply warranted the exercise of the equitable power of the Bankruptcy Court to deny the landlord's petition for possession of the premises." (Parenthesis added)

In the case at bar, the Landlords would receive a windfall of over $1,000,000.00 above outstanding encumbrances, and also, no plan of reorganization could be formulated if such were permitted.

To allow the Landlords, who owned property which originally cost them $3,100.00 and was worth $150,000.00 at the time of the hearing of this matter, to possession of a hotel which was built and equipped by the tenant and now worth $2,000,000.00 would constitute a windfall at the expense of the creditors, stockholders and debentureholders. This, we respectfully submit, would be grossly inequitable, unconscionable, unjust and shock the conscience of this Court.

The Petitioners cite many Federal decisions wherein the Court applied Section 70(b) of the Bankruptcy Act and enforced a forfeiture of the leased premises. These decisions are not at all in conflict with the holdings in the instant case; however, the question of enforcement is determined under each individual circumstance.

There is one major distinguishing factor which has caused the Courts to apply their inherent power of equity. Where the landlord built the improvements on the land and the lessee goes bankrupt, the Courts have not hesitated in upholding a forfeiture. However, where the tenant is largely responsible for the improvements, the Courts have not allowed the landlord to gain

a windfall and have refused the relief on equitable principles.

In examining the cases cited by the Petitioners and decided by other Courts, there is *not* one case wherein the Court allowed a forfeiture of the premises when the lessee was responsible for the improvements.

In the recent case of *In Re Imperial "400" National, Inc.*, 3rd Cir., 429 F 2d 680 (1970), the Third Circuit again reiterated its former position stated in the *Fleetwood* case and held that the appointment of a trustee in reorganization did not constitute a breach of an express covenant in the lease. The Court stated that forfeiture clauses are liberally construed in favor of the bankrupt and the forfeiture clause did not specify the appointment of a trustee in reorganizattion.

The petitioners rely upon the North Carolina decision of *Carson v. Imperial "400" National, Inc.*, 267 N. C. 229, 147 S. E. 2d 898 (1966), which involved the identical corporation and lease as the *Imperial* case decided by the Third Circuit. However, Imperial "400" had sublet the premises to a limited partnership and this limited partnership raised the defense that forfeiture did not apply to them, but only to Imperial who was not in possession. The North Carolina Court held that the forfeiture clause was valid and allowed a forfeiture as to the limited partnership. There are several distinguishing factors between this case and the case at bar:

1) The limited partnership, a sublessee, did not construct the motel.

2) The limited partnership did not request the North Carolina Court to apply its equitable powers.

3) The position of the limited partnership was that the forfeiture provision applied only to the original lessee and not to it as an assignee of the lease now in possession.

4) The Court's decision was solely and strictly founded on the principle that the assignee was bound by the provisions of the lease.

5) The lease before the North Carolina Court was one of many held by the Debtor and forfeiture would not preclude a reorganization.

It is respectfully submitted that the North Carolina Supreme Court would have denied the relief requested had it been asked to apply its equitable powers and been shown an unconscionable forfeiture and a windfall to the landlords of $1,000,000.00 as in the case at bar. The North Carolina Supreme Court, in the case of *Morris v. Austraw*, 269 N. C. 218, 152 S. E. 2d 155 (1969) seven months following its decision in the *Carson* case, quoting from 32 Am. Jur., *Landlord and Tenant*, Section 848, stated:

> ". . . As has been said, the right to declare a forfeiture of a lease must be distinctly reserved; the proof of the happening of the event on which the right is to be exercised must be clear; the party entitled to do so must exercise his right promptly; and the *result of enforcing the forfeiture must not be unconscionable.*" (Emphasis added)

The United States Court of Appeals for the Fourth Circuit refused to allow a forfeiture in the case at bar based upon the rationale of the *Smith* and *Fleetwood* decisions where as here a forfeiture would be the complete emasculation of the reorganization because the entire res would be removed from the estate of the Debtor.

Conclusion

It is respectfully submitted that Petition for Writ of Certiorari should not be granted and as Judge Bryan, in denying the petition for rehearing, so aptly stated:

"(T)he Landlord's insistence upon a forfeiture was highly unconsionable and inequitable in the circumstances—a demand for blood."

Respectfully submitted,

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Certificate of Service

THIS IS TO CERTIFY that I have this date served two (2) copies of the foregoing Brief in Opposition to Petition for Writ of Certiorari on the attorney of record listed by mailing same to him by United States Mail, postage prepaid, to his office address, as follows:

Mr. Charles B. Nye, Nye & Mitchell, Post Office Box 1131, Durham, North Carolina 27702.

This the 15 day of August, 1972.

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